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During the past 20 years the reputation of central banks has expanded far beyond their true stature and accomplishments. The heads of the most prestigious banks have been placed on lofty pedestals, from which descent can only be abrupt and painful. Paul Volcker, a worthy candidate for the epithet of giant, left while the going was good. Alan Greenspan, while highly regarded in financial circles in 1998, must live in daily dread of the global financial catastrophe that will shatter his reputation.

Debt and Delusion: Central Bank Follies that Threaten Economic Disaster
Peter Warburton, Allan Lane, The Penguin Press, 1999

Endemic Deformation

What will be the next major move in the world economy? Ever since the central banks around the world embarked last autumn on their great binge of rate cuts, relieved investors and speculators eagerly snapped up the "great reflation" theme, peddled unanimously by economists and analysts. It said that such massive easing must essentially result in a synchronized global economic recovery and that this will be bullish for stocks. Thanks to this message, cyclical stocks became the great rage in the stock markets.

It appears that the economists of the international organizations are not among those who have bought this story of a strong global recovery. For the industrial countries, little change in growth is expected. Somewhat slower growth in the United States is supposed to be offset by some improvement in Europe and Japan. Actually, there is an unusually high degree of divergence in economic performance both among the industrial and the developing countries. For every brightening spot (Korea, Brazil, Mexico) there is a darkening spot (China, Argentine, Chile).

We continue to hold the view that the major risks to the world economy lie not in Asia, Latin America or Europe, but in America, more precisely in the American bubble economy. If the U.S. credit and stock market bubble bursts, it means disaster for the world economy, not unlike 1929. It is the magnitude of the credit excesses and the sheer recklessness of financial behavior that sets the U.S. experience apart from anything before.

In this letter, we have extended our analysis from the financial excesses to the attendant imbalances, maladjustments and malinvestments in the economy that now enjoy complete disregard. In particular, we have taken another critical look at real GDP growth, distinguishing between the soaring part of computer manufacturing and the declining part of the 98.8% of the economy located outside of the computer sector. This distortion has become grotesque.

ODD OMENS

If American stocks did put in their highs in mid-July during the height of earnings reporting season, one can give considerable credit to the powerful Wall Street propaganda machine. Spin now has it that corporations are in the midst of an earnings and technology-driven productivity explosion. With interest rates rising, the many beneficiaries of the great American bull market are pulling out all the stops to perpetuate the bubble. Anticipation of double-digit earnings growth was the justification given to the new bull run of the stock market. The dramatic surge in tech stocks was definitely exacerbated by derivatives and heavy short covering. We, however, tend to assign greater importance to the recent poor performance of the financial stocks as indicators of increasing American financial vulnerability. Meanwhile, the ongoing bear market in U.S. fixed-income securities overshadows faltering stock prices.

As selling pressure developed in the bond market, the "middle of the curve," particularly with 5 and 10-year

Treasury notes being extensively used for hedging and derivative strategies, has suffered the most acute losses. In addition, spreads are widening across the board. Increasing spreads for the debt of the money center banks and brokerage firms give a clear sign of heightened risk perceptions.

The precarious point is that a security issuance boom of unprecedented proportions is hitting a market that, in the absence of new savings, depends completely on new leveraging—that is, on short-term borrowing—as a source of funds. Consider that since Geenspan's bailout early last fall, about $1 trillion of new securities have been issued, of which the vast majority are now "under water." Additionally, there is a mad rush to securitize asset-backed and mortgage-backed paper. With liquidity faltering, yields are poised to surprise on the upside, with spreads certainly widening further.

Not surprisingly, there are signs of unfolding dislocation in derivatives. Ten-year swap spreads are at their highest levels in at least 10 years, surpassing even the extremes in last fall's crisis. These spreads traded as high as 100 on July 23, up more than 30 basis points since mid-May. For comparison, the average of this spread over the past ten years is 51. This change comes with an alarming explosion of derivatives that have been allowed to grow to more than $100 trillion.

All this suggests a serious impairment unfolding for the highly leveraged speculating community. On top of the losses at the hands of higher U.S. interest rates, increasing losses in the emerging market debt area, especially in Argentina, are now coming. Emerging market debt spreads have widened about 350 basis points since early May with worries as diverse as Latin American defaults, debt downgrades, potential devaluations and worries about the confrontation between China and Taiwan. Many speculators also suffered from the slide in the euro and the sell-off in European bonds. Certainly the biggest losses have occurred in the "yen carry trade," which in expectation of a weak and falling yen huge positions had been built up. To everybody's surprise, the high-yielding dollar is sinking against the low-yielding yen. With increasing credit market dislocation and faltering U.S. share prices, market perceptions appear to have shifted against the dollar with strong gains for euro and Swiss Franc.

Newfound dollar weakness and general currency instability would, for sure, seriously add to the developing strains in the U.S. financial markets. We think the potential ramifications for the American financial markets of a significant waning of dollar confidence cannot be overstated. A falling dollar, by the way, is Europe's nightmare.

The U.S. trade position, at all events, is spiraling out of control. With expectations for $19.2 billion, May posted a trade gap of $21.3 billion, a 40% increase from a year ago. For comparison, the trade gap was $14 billion in May 1998 and $8 billion in May 1997. Over the past two years, goods exports have declined 2% to $56 billion, while imported goods have increased 14% to $86 billion. Prior to the Asian meltdown in mid-1997, American goods exports were growing at 27% annually. In the second quarter of 1999, the trade gap appears to have widened to $340 billion from $303 billion in the first quarter.

BUBBLE BABBLE

Alluding in one of his testimonies before Congress to the great bull market of the 1990s, Mr. Greenspan sighed that it was "difficult to assess" whether "an unstable bubble" had "developed in its wake." For some time already, we have been wondering whether the revered chairman of the Federal Reserve Board is just faking ignorance about the existence of a bubble or whether his blindness is genuine.

From what he wrote many years ago about the causes of the stock market crash of 1929 and the following Depression, you have to conclude that he perfectly knows the essence as well as the dangers of an asset bubble. It happens, of course, that over time economists radically change their mind. Still, we think Mr. Greenspan must be aware that the U.S. stock market boom is a bubble in the sense that it is chiefly fueled by credit excess. Rather

he appears convinced that he is the central banker to finesse it with little damage to the economy. Wasn't he highly successful last autumn?

His remark in a congressional testimony that the economic consequences of a bursting bubble, while "scarcely benign," needn't be "catastrophic" if the Fed responds appropriately, as it did in 1987, certainly points in this direction. In contrast to what he wrote in 1966, he seems to share now the conventional view among American economists that the disastrous economic aftermaths of 1929 in the United States and 1989 in Japan were by no means an inevitable consequence of the prior credit and spending excesses but the result of fallacious policies followed after the bubbles had burst.

In our view, the decisive mistake in the assessment of asset bubbles and associated "bubble economies" has always been that the damage to the economy and the financial system through attendant financial and economic dislocations is grossly underrated. As we have repeatedly stressed, looking at bubbles, it is necessary to distinguish between the asset bubble as such and the inherent dislocating effects it has on the economy and the financial system. These latter have always proved the most serious part of the problem, depending on their magnitude. This is really the gist of Austrian theory.

In Japan's case, the stock market and land price bubble impacted the economy overwhelmingly through extraordinary booms in investment spending, both real estate and business plant and equipment. Though household net worth soared, the direct effect on consumer spending was relatively small. And the same is true of the bubbles in Southeast Asia. Remarkably, the great American bubble of the late 1920s went already overridingly into consumption, accounting between 1927-29 for virtually total GDP growth.

Likewise notable is Mr. Greenspan's further statement that most asset bubbles can be recognized only "after the fact." To spot one in advance, he insisted, "requires a judgment that hundreds of thousands of informed investors have it all wrong." All of a sudden, Mr. Greenspan bristles with intellectual modesty, finding it apparently inconceivable that he might know better than the crowd in the markets. If you think it's over, this really is an unbelievable statement from a central banker, in this case from the head of the world's leading central bank.

It hardly needs pointing out that market participants and central banks do, essentially, have entirely different perspectives and objectives. Investors and speculators legitimately look at the markets with one single target in their mind: to make as much money as possible. Most of them neither care, nor are they obliged to care, whether or not the booming market is driven by sound fundamentals or by a "credit bubble." For that, the responsibility lies exclusively with the central bank. Actually, investors and speculators are heavily guided by the actions and signals on the part of the central bank.

Money supply growth well in excess of GDP growth, tolerated and implemented by the central banks, has, in fact, been the stock argument of the bulls for this bubble. More than any other central banker, Mr. Greenspan has in words and deeds been permanently flashing green light for unfettered speculation. If he had made a deliberate decision to create and to sustain the biggest credit bubble in history, he couldn't have done better than he effectively did in the last four years. No doubt, Mr. Greenspan is for the boom. Far from being concerned, he is the man most responsible for it.

SPOTTING A BUBBLE

Is it really so tough to identify an "asset price bubble"? The old economists had it, theoretically at least, in their little finger because they had a strict concept of the essence of inflation and economic equilibrium, to start with. Mr. Greenspan obviously lacks such conceptual guidance. Though repeatedly speaking of dangerous imbalances in the U.S. economy, using the plural, he keeps mentioning just one: the tight labor market and the threat of wage inflation to price inflation.

The truth, though, is that to overheat a labor market requires an excessive creation of purchasing power in the first place. Rising labor costs, by themselves, are not able to cause inflation. The indispensable condition for inflation is always an accommodating credit expansion, provided by loose monetary policy. Wage inflation is just one of various possible symptoms of an excessive credit expansion.

This leads us to the key question of economic equilibrium: Just when is a credit expansion excessive? The simplistic answer of most American economists today, including Mr. Greenspan, is when it occasions a rise in the price level for goods and services, as measured by the producer and consumer price indexes. This is, for them, the all-important gauge of existing inflation. Literally nothing else is taken into consideration: neither money growth nor credit growth, neither negative savings nor the huge and soaring gap in the balance of payments. Imbalances of any size in the economy and in the financial system don't matter, in this view, as long as they do not affect the price indexes. One utterly absurd outgrowth of this rationale is that in this psychological setting there is literally no limit to credit expansion as long as the conventional price indexes remain well-behaved. It is economics at its lowest level.

THE KEY GAUGE TO CREDIT EXCESS: AVAILABLE SAVINGS

Back to Greenspan's assertion that "bubbles" are difficult to spot. In reality, it is an easy task. The answer lies in the classical concept of economic and financial equilibrium, with which macro-economic thinking started more than 200 years ago. It says that non-inflationary credit expansion has its limit in available savings, a view, by the way, which used to be shared by all schools of economic thought.

Basic to this equation are three considerations: first, credit-financed spending absorbs real and financial resources; second, the release of these resources takes place through saving out of current income; and third, it is the function of interest rates to keep the two aggregates (credit and savings) in balance. This recognition of the necessary equation of new credit and new saving has always belonged to the elementary insights in economics. Interest rates that are too low, essentially, result in too much credit, that is, in credit excess.

The problem with Mr. Greenspan and the great majority of American economists is that they are great number crunchers without a theory. This ill-balanced approach was established in the United States by Prof. Wesley C. Mitchell before World War I. Mr. Greenspan, in particular, has the reputation of being a meticulous student of even the most peculiar numbers. The result is a unique torrent of statistics in the United States. This single-minded obsession with the price indexes is coupled with a complete negligence of even large economic or financial maladjustments, such as runaway credit expansion, collapse of personal savings, the huge and soaring trade deficit, etc.

It is a historic fact that the great thinkers in economics were all Europeans, above all Austrians, Swedish and British. The essence of economic theory is the disclosure of causes and effects, especially the long-run effects of any change in the economic and financial system. To quote Ludwig von Mises on this point:

> The short-run effects are for the most part obvious and seldom escape the notice of a naive observer unfamiliar with searching investigations. What started economic studies was precisely the fact that some men of genius began to suspect that the remoter consequences of an event may differ from the immediate effects visible even to the most simple-minded layman. The main achievement of economics was the disclosure of such long-run effects hitherto unnoticed by the unaffected observer and neglected by the statesmen.
>
> There are certainly, both in the actions of individuals and in the conduct of public affairs, situations in which the actors may have good reasons to put up even with undesirable long-run effects in order to

avoid what they consider still more undesirable short-run conditions. It may sometimes be expedient for a man to heat the stove with his furniture. But if he does, he should know what the remoter effects will be. He should not delude himself by believing that he has discovered a wonderful new method of heating his premises.

Most obviously, for the American economists of today nothing but short-term effects count. The wholesale collapse of personal saving, through fueling the consumer spending boom, has chiefly powered the strong real GDP growth. From this perspective, the saving collapse had an obvious, highly beneficial effect on the economy. For most American economists, that's it. Any questions about sustainability and inherent adverse long-term effects of this saving collapse are neither considered nor discussed.

FINANCIAL ANARCHY

Back again to Mr. Greenspan's remark that "bubbles" are difficult to identify before they burst:

To begin with, please contrast his recent statement with what he wrote in 1966 about the cause of the stock market crash in 1929: "The excess credit which the Fed pumped into the economy spilled over into the stock market—triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sip up the excess reserves and finally succeeded in braking the boom. But it was too late: by 1929, the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and consequent demoralizing of business confidence." (*The Objectivist,* 1966)

At that time, then, Mr. Greenspan was well aware that credit excess, stoked by the central bank, had propelled the boom-bust of the late 1920s. Well, compared to the credit excesses that he has sanctioned during the last years, those of the late 1920s look like child's play. One way or the other, good old economic and credit theory had a precise answer to the question of what makes a credit excess or an asset bubble: a credit expansion exceeding current savings.

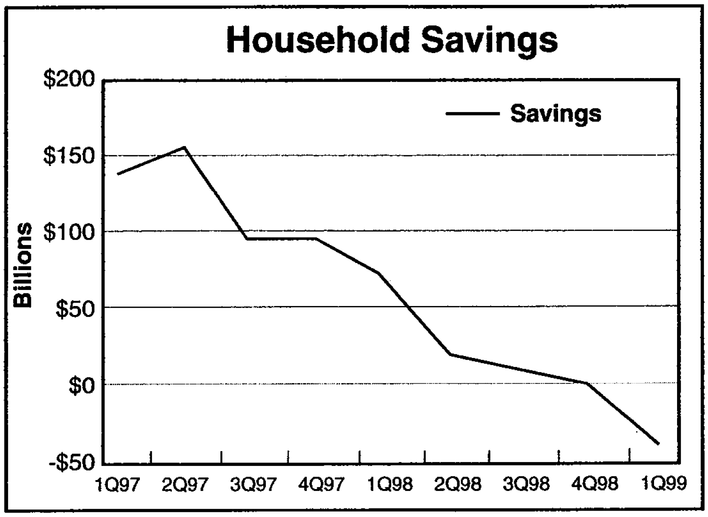
It is the function of financial systems to intermediate and to allocate available savings to potential borrowers. But more often than not, the flow of savings is more or less supplemented by inflationary sources of funds, of which there are two kinds: first, excessive credit supply; and second, a general rush out of cash balances and into securities. The old economists called this "dishoarding." Or, to put it into Keynesian language, plunging liquidity preference. Plainly, the U.S. bubble has been propelled by both mechanisms.

"Excess credit," to repeat, means credit growth in excess of available savings. It's as simple as that. How does that look in the U.S. case? For good reason, we have continuously chronicled it. Total credit creation in the financial and the nonfinancial sector amounted to the staggering amount of $2.1 trillion in 1998, while underlying savings became negative. Such a preposterous gulf between credit creation and available savings is absolutely unprecedented in history. In the light of these facts and figures, the U.S. financial boom is definitely more than just another bubble. It is the worst bubble in history, by far. It is really financial anarchy. Consider that Japan in its bubble years of the late 1980s had a net savings ratio of almost 20% of GDP.

PHONY WEALTH CREATION

American economists like to glorify the efficiency of unregulated, flexible markets in general and of their own financial markets in particular. For sure, in the sense of capacity to create virtually unlimited credit for financial speculation and leveraging the American financial system is the most efficient in the world. But is that a desirable efficiency?

The bullish consensus has it that the profligate wealth creation by the booming stock market has made saving out of current income for America obsolete. We are not aware that any renowned economists have supported this nonsense. Still, it strikes us that hardly anyone contradicts this silly talk and expresses anxiety about this disastrous development of personal saving, definitely not Mr. Greenspan, for example. Nobody, apparently, wants to blemish the radiant perception of a faultless U.S. economy that fully justifies the extraordinary stock market boom.



In his congressional testimony of Feb. 4, 1999, Mr. Greenspan actually came close to confirming the complacent, bullish view about the saving collapse, stating: "Arguably, the average household does not perceive that its saving has fallen off since 1992. In fact, the net worth of the average household has increased by nearly 50% since the end of 1992, well in excess of the gains of the previous six years. Households have been accumulating resources for retirement or for a rainy day, despite very low measured saving rates."

One single voice of warning has come to our attention. It was from Mr. Lawrence B. Lindsey, former governor of the Federal Reserve. In an article in *The Wall Street Journal*, he pinpointed the saving collapse as the most important and most dangerous dislocation in the U.S. economy.

But, remember the earlier quote from Mises, the conundrum of economic changes always lies in the long-term effects. The point to see in this case is that in order to maintain his rate of increase in spending, the American consumer must exponentially compound his dissaving at the same rate. Last May, the personal saving rate hit a new record of minus 1.5% of disposable income, compared with a positive savings rate of 0.5% last year and of 2.1% in 1997. Now, just to maintain the growth of consumer spending, the negative saving rate has to rise next year to 3% and in 2001 to 4.5% of disposable income. Over those three years, U.S. households would have spent about $720 billion more than they earned, and by 2002 would be drawing down their wealth at an annual rate of $500 billion. Just imagine, the U.S. economy, supposedly with the healthiest fundamentals in the world, no longer has a saving rate but a dissaving rate. That, indeed, is a very "new paradigm."

But assuming that this is the whole story is like reading the last chapter of book. There is another most important second aspect to this wealth creation powering consumer spending. It concerns one sentence in the above quote of Mr. Greenspan: "Households have been accumulating resources for retirement or for a rainy day, despite very low savings rates." To hear such nonsense from a central banker of the rank of Mr. Greenspan is frightening. Wealth creation through capital gains in the stock market involves zero, we repeat, zero creation of resources in the economy. Genuine wealth creation requires the creation of productive resources for higher production in the future. In other words, it implies capital formation.

But what has taken place through the huge capital gains in the U.S. stock market is not an "accumulation of resources" with a future benefit to the economy as a whole but the exact opposite: the accumulation of rising claims on existing resources. The higher stock prices provide the stock owners with potential purchasing power which they have partly used for higher spending on consumer goods and services, and the decline in the savings rate is equivalent to a rise in the share of output that is consumed. For the ultimate effect of such a resource shift, the old economists had a simple formula: Capital decreases when the community consumes more than it

produces. Capital increases when the community produces more than it consumes. America has for long been a low-saving and low-investment country. Now, it is a capital-consuming country. That's a kind of progress.

Low U.S. national saving was in the past customarily blamed on the government's budget deficit. Although that was an important contributing factor, it was far from the whole story. The more important factor since the mid-1980s has been low and declining private saving. While the government finances have since then progressively improved, with the budget now even in substantial surplus, private saving has declined ever faster.

THE PRODUCTIVITY MYTH

Evidence that the U.S. economy still has an extremely powerful head of steam behind it continues to accumulate. It seems to go from strength to strength. Critically, U.S. inflation has, nevertheless remained extremely low, with the most recent data showing core inflation at 2% year over year, the lowest since the early 1960s, but the highest among the major industrial countries. At whatever part of the U.S. economy you look, it's booming, except industrial production.

Yet, the greatest boom of all continues to be in the credit numbers. In the first quarter, the nonfinancial sector, mainly businesses and consumers, amassed another $1.112 trillion of new debt (at annual rate), a new record increase, compared to nominal GDP growth of $474 billion, also at annual rate. For each dollar added to GDP, there were $ 2.34 added to credit and debt. Or, reciprocally, on average, each dollar of new debt generated only 42.6 cents of additional spending on goods and services and, implicitly, corresponding income growth. The use of debt in the American economy no longer bears any relationship to economic growth. Most of it oils the wheels of financial speculation.

Assessing the economy's performance, American economists and even American policymakers focus on just five aggregates as summary measures of economic health: real GDP growth, the conventional price indexes, employment growth along with the unemployment rate, productivity gains and the stock market. Perceiving the stock market as the best judge of economic performance, the long surge in stock prices is readily regarded as confirmation and appropriate hallmark of the "new paradigm" economy.

More than anything else, it is the convergence of strong economic growth and retreating inflation that has kindled the "new paradigm" fantasy. The ready bullish explanation of this economic "miracle" again and again advanced by Mr. Greenspan, is the rapidly spreading application of computer technology throughout the economy, boosting productivity while helping to contain inflation. All this is presented with a maximum of certitude and a minimum of analysis.

In the June letter, we have tried to explain and to demonstrate that the brightness of the U.S. economic picture in recent years owes everything, literally everything, to the outsized contributions of the computer industry and the peculiar way its production growth is measured. "If computer output is taken out of the GDP accounting in chained dollars," we wrote, "all of the 'new paradigm' luster - strong economic growth, sharply higher productivity gains and falling inflation rates - dissolves into thin air."

We can imagine that many readers have had great difficulty in accepting this devastating contention. Therefore, we decided to return to this question and to present the evidence this time in hard numbers. Meanwhile, we have noted that we are not alone in having made this discovery. In its July 12 issue, *Business Week* reported under its feature "Economic Trends" about a study by Robert J. Gordon of Northwestern University that comes to exactly the same conclusion that the acceleration in long-term productivity growth has occurred entirely within the computer industry. On balance, the author notes, "there has been no productivity acceleration at all in the 98.8% of the economy located outside of computer and related technology manufacturing."

If you take a closer look at the following table, you will realize the hollowness of the prevailing "new era" or "new paradigm" euphoria.

U.S. ECONOMIC X-RAY (1995-1999)

	95	96	97	98	I	II	III	IV	I
1. GDP GROWTH*	151.0	233.1	275.0	282.1	100.1	33.9	67.9	111.2	77.0
2. RATE OF GROWTH IN %	2.3	3.4	3.9	3.9	5.5	1.8	3.7	6.0	4.3
3. COMPUTER OUTPUT*	22.2	41.3	82.0	137.0	49.3	39.3	39.0	42.5	37.3
4. IN % OF TOTAL GDP GROWTH	14.7	17.7	33.5	48.6	49.2	116.0	57.4	38.2	54.0
5. GDP GROWTH EX COMPUTERS*	128.8	191.8	193.0	145.1	50.8	-5.4	28.9	68.7	39.7
6. RATE OF GROWTH IN %	1.96	2.80	2.74	2.01	2.79	-0.29	1.57	3.71	2.22
7. PRODUCTIVITY GROWTH**	0.3	2.7	1.5	2.4	4.1	0.1	2.6	4.6	4.1
8. INDUSTRIAL EQUIPMENT*	10.3	2.2	7.5	6.8	2.9	1.0	0.6	0.4	- 2.3
9. PERSONAL SAVING RATE	3.4	2.9	2.1	0.5	1.2	0.4	0.2	0.0	-0.6
10. TRADE DEFICIT*	99	114	136	238	198	245	259	250	310
11. NONFINANCIAL CREDIT***	700	693	723	937	906	909	843	1,089	1,002
12. FINANCIAL CREDIT***	456	557	652	1,068	933	987	1,055	1,298	1,202

*increase in chained dollars, ** increase in percent, *** increase in current dollars
Source: Survey of Current Business, Federal Reserve Flows of Funds.

Yes, the U.S. GDP statistics show for the last two years a marked acceleration in economic growth in connection with a spurt in productivity growth. As we have repeatedly noted, Mr. Greenspan himself keeps attributing these gains to heavy corporate investment in high tech which at long last is bearing its expected fruits. That's, of course, the story that also Wall Street likes and trumpets.

Indeed, the whole of the acceleration in U.S. real economic growth during the last years has come from computers, as confirmed in line 3. But look out, what you see there is not the upshot of computer application. It is unmistakably the upshot of a steep increase in computer output, as measured in the GDP statistics by the additions to computational power. Over this period of four years, the share of computer manufacturing in real GDP growth has literally exploded from 14.7% in 1995 to 48.6% in 1998, hitting in the first quarter of 1999 even 54%.

Looking at the table, it further strikes the eye that the sudden jump in productivity growth during 1998 concurs distinctly with the soaring contribution of computer output to real GDP growth (lines 4 and 7 in the table). There is no reason to be surprised. It is a matter of simple arithmetic that what adds so heavily to real GDP growth essentially adds correspondingly to productivity growth. The unappreciated fact is that this explosive rise in computer output has masked mediocre output and productivity growth in the "98.8%" of the economy located outside of the high tech sector. It should be clear that this larger part of the economy is representative of the whole. But the growth of this part has, actually, decelerated in 1998 to 2%, after 2.74% in 1997 (line 5).

A CONGLOMERATE OF IMBALANCES

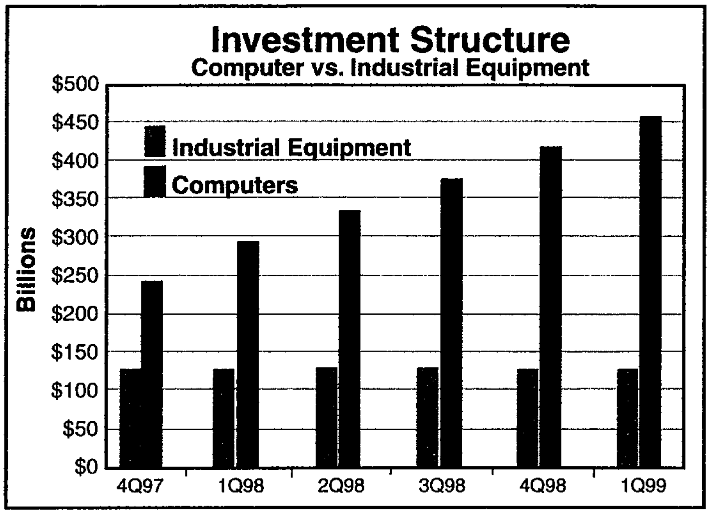
For certain, this slowdown in domestic output (ex computer manufacturing) was not due to shrinking domestic demand. To what else then? Line 10 of the table exhibits the culprit: the exploding trade deficit. It indicates that the booming domestic demand has poured overwhelmingly abroad. While GDP growth, ex computers, slowed drastically from $193 billion to $145 billion, the trade deficit ballooned from $136 billion to $238 billion. This pattern has continued in the first quarter of 1999. A decline in real GDP growth (ex computer manufacturing) from the prior quarter by $34.2 billion tallied with a further widening of the trade deficit by $60 billion, both at annual rate.

And what has been causing this massive diversion of domestic demand into imports? We see two main reasons: first, the strong dollar; and second, a lack of investment in industrial equipment (line 8) which implies

insufficient manufacturing capacity growth in comparison with the surge in domestic demand. See also the chart below, showing the immense disparity between investment in computers and investment in industrial equipment.

This table on the prior page, in effect, exposes the U.S. economy as a conglomerate of monstrous economic and financial imbalances, all of them attributable to one and the same universal cause: virtually infinite credit creation (lines 11, 12) against the backdrop of a collapse of personal saving (line 9). The resulting gulf between credit and savings is not just an imbalance. This looks rather like financial anarchy. It is so preposterous that it keeps us wondering whether the majority of American economists, and Mr. Greenspan in particular, proclaiming an economic miracle, are truly as ignorant as they appear, or whether they just try to fan the boom against their better knowledge.

We presume, there is something of both at work. Macro-economic thinking is today definitely at its lowest level in decades. More precisely, it's completely absent. There has been a collective departure from this kind of thinking and with it from the capacity of individuals to discern serious maladjustments in the economy. When even Mr. Greenspan displays notorious indifference to what happens to credit, savings and the balance of payments, what can you expect from the ordinary economist?



After the credit-savings gap the most spectacular imbalance is in the prodigious export-import gap (line 10), having skyrocketed recently to an annual rate of $310 billion in chained dollars, as measured in real GDP accounting. It used be known to beginners in economics that an external deficit is about equal, by definition, to the excess of domestic demand over domestic output and that, depending on the nature and the size of the import surplus, this may rank as a great negative for an economy. No longer, certainly not in America. In the rosy "new paradigm" perception of U.S. policymakers and Wall Street bulls the trade deficit is a hallmark of economic health and strength, due not to domestic overconsumption but to soaring capital inflows, reflecting the desire of foreigners to invest in the United States.

Well, it's easy enough to check the truth. The answer lies in the changes that have occurred in the composition of the trade deficit. What is the dominating factor in the enormous import surplus? Consumer goods or capital goods? Is America in its foreign trade a net importer of capital goods or of consumer goods? In short, of the latter. To emphasize the main point: the soaring U.S. trade deficit is closely associated with the soaring level of domestic spending on consumption and the dramatic decline in the personal saving rate, and this inherently implies that America is using its vast capital inflows clearly not for higher domestic capital formation but exclusively for higher consumption, in other words, for capital consumption. Its manifest counterpart is the surging share of consumption in the composition of GDP growth.

The exploding trade deficit is one essential result of the consumer spending binge. Retail sales have been booming as never before in foreign luxury cars and items such as Swiss watches, Italian handbags, multimillion-dollar yachts and Gulfstream corporate jets. Another essential result, much less visible, is a tremendous boom in all kinds of consumption-related structures. Most importantly, of course, real estate markets are seething throughout the country with sales and new construction for 1999's first half at record levels.

But within this national real estate boom there are red-hot regional areas with unbelievable excesses. Las Vegas now has almost 110,000 hotel rooms, and another 16,000 are on the way. Over the past several years, monstrous projects have been constructed including the MGM Grand, Luxor, The Orleans and the Stratosphere.

Last October, Mirage Resorts opened the Bellagio, complete with a $285 million art collection, at a total cost of $1.6 billion. The Venetian, 32 stories with 3,000 full suites, a $300 million shopping mall and 15 restaurants, was constructed for $1.5 billion—to give just a few examples of long list of such fanciful projects in a world where the central bank has sanctioned a free-for-all in credit creation.

THE YEN, THE DOLLAR AND THE EURO

How strong is the dollar really? If you look at the euro, it has until recently appeared very strong. If you look at the yen, it is very weak, considering the rock-bottom Japanese interest rates and the massive interventions by the Bank of Japan that are needed to prevent the dollar from falling through the floor. What is it that has made the great difference between yen and euro in their relation to the dollar?

From the report of a leading brokerage house, we learned the following explanation: "The real story of this year's weakness in the European currency has been a dramatic downshift in the pace of economic activity—average annualized gains of just 1.6% in Euroland GDP over the two-quarter interval ending in IQ99. This sluggish increase stands in sharp contrast to the 5% average growth in the U.S. economy and the 2.3% average gains in Japanese GDP reported over the same interval. Euroland sticks out quite prominently as the weakest link in the G-3 growth chain."

Although this comparison, covering merely six months, gave a grossly distorted picture of underlying trends, it effectively swayed the currency markets for half a year. In particular, the German and the Italian economy were branded as the hopeless laggards, though this weakness principally reflected Asia-related lower exports and inventories. According to OECD estimates, overall real GDP growth in Euroland is supposed to slow this year to 2.1%, after 2.9% last year. Indeed, that's a slowdown, though hardly a catastrophe that justifies a plunging currency.

RECOVERY IN JAPAN STILL A CHIMERA

What about the Japanese economy and the buoyant yen? Is the economy bursting with new strength that has been propelling both the yen and the Tokyo stock market higher? Just imagine, the Nikkei among the major bourses in the first half of this year has scored the biggest gain, fully 30%. What has happened there to explain this extraordinary performance?

Well, chiefly under the impact of heavy public construction spending, Japan's GDP for 1Q99 had a sudden spurt, 7.9%, annualized, following a decline in the prior quarter by 3.2%, also annualized. Together, this makes an average gain in GDP for the six months of 2.3%, as specified in the above quote. But what was behind this real GDP spurt? Will this government-induced upturn in one single quarter transmute into a self-sustaining, robust recovery? That, of course, is the salient question. Numerous international investors and speculators answered this question instantly with a resounding yes and poured their money into Japanese stocks.

Drawing our information about Japan's economy primarily from the Bank of Japan and the OECD in Paris, we have to admit that we are flatly unable to join the chorus extolling the underlying strength of this upswing. A few mini-recovery signs in the economy are grossly outweighed by major depressive signs. Appraising the spurt in the first quarter, two things ought to be taken into account: first, that it was overwhelmingly government-sponsored; and second, that this spurt occurred in an economy where output has fallen by more than 5% since the recession began in 1997.

What those messengers of economic recovery in Japan generally seem to overlook is the inexorable growth in potential output. Just to stand still in terms of capacity utilization, the economy has to expand by at least 3% annually. Measured against potential growth, substantial shrinkage continues across the whole economy. Only housing seems to have touched bottom. To quote the latest OECD report: "There has been no let-up in the pace

of decline in business investment, as firms continue to recognize the extent of their existing excess capacity...Saving propensities of the consumer reached a record high in the first quarter of this year, and household incomes have continued to be squeezed by the dual effect of wage and employment cutbacks." Ominously, the export surplus is no longer founded in rising exports but in declining imports.

The salient point, in fact, is that the overall slack in the economy, as measured by actual against potential output growth, is by no means receding but dramatically widening. According to OECD estimates, Japan's output gap will hit this year a new high of 4.3%, after 2.5% in 1998, rising in 2000 further to 5.1%. In other words, excess capacity is growing, not shrinking, despite drastic cuts in business investment spending. For comparison: The euro economy's average output gap is for the current year estimated at 1.6%, slightly up from 1998, but slightly down from 1996-97.

What the relentless growth in excess capacity tends to do to Japan's economy hardly requires much explication. It is sure to intensify the downward pressure on prices, and that essentially at the expense of business profits. Consumer prices have been edging down since last summer. Other measures of prices show more substantial declines. Japan's economy, in short, remains in the grips of outright deflation, and far from easing, the deflationary pressures are aggravating.

We have dealt with the recent development in Japan's economy in some detail because the conjecture of its imminent rebound has played a crucial role in shaping certain expectations governing currency and financial markets. Most prominent and most important among them is the presumption that the recovery of Japan's economy will provide substantial zip to the synchronized global recovery, on which many economists, investors and speculators have lately been betting in the currency and the financial markets. For the time being, we regard the expected and predicted recovery of Japan's economy as a chimera. If it would actually happen, by the way, it would savage the dollar even more than a weak Japanese economy.

All the more perplexing, in the light of this disastrous economic background in Japan, is the strength of the yen. A shrinking economy with virtually zero short-term interest rates has a currency that threatens to go through the roof against the dollar. Therefore, we wonder whether yen strength is the correct perspective. Perhaps, there is predominantly dollar weakness at work. By no means is this differentiation between the two possibilities just semantics. It has a most important implication, namely in that dollar weakness against the yen may be the forerunner of general dollar weakness, also against the euro. Definitely, the European economy is in far better shape than that of Japan.

WHAT COULD PRICK THE U.S. BUBBLE? A COLLAPSING DOLLAR

In the consensus view, the only thing that might possibly prick the American credit bubble is an overheating economy with rising inflation rates that will force Mr. Greenspan to tighten his monetary reins. It has always been our belief that this will not happen. First of all, we have a radically different view about the inherent stability and strength of the U.S. economy; and second, we were sure that Mr. Greenspan would under all circumstances avoid a serious tightening.

Our hunch has all the time been that the American bubble would be pricked by precisely the opposite incidence, that is by a weakening U.S. economy that would pull the rug from under the dollar. The greatest jeopardy for the bubble is not Mr. Greenspan or a rising inflation rate in the United States, but a plunging dollar. The ups and downs of the dollar are closely tied to the ups and downs of the U.S. business cycle, in particular to a business cycle mismatch between the United States and Germany. Just think of the dollar's even steeper rise during 1982-1985 under very similar circumstances. The U.S. economy—experiencing strong growth with falling inflation rates, though from a higher level than in the 1990s—was generally extolled to have gained new

dynamism under Reaganomics, while Europe's economy was derided for "Euro-sclerosis." Ergo: the strong dollar would therefore prevail in eternity. What was to follow in the second half of the 1980s was a dollar collapse lasting for years.

We wonder about the chief differences between the global situation in 1985-6 and that of today. There are many differences and many similarities. One of the most important aspects in our view is that a weak dollar and its adverse impact on inflows of foreign capital was behind the rise in U.S. interest rates back in 1987, which sent global stock markets crashing. There is a cliché that any international crisis essentially strengthens the dollar because America and its currency are regarded as the safe haven. But this was not true in 1987. Nor was it true in last year's turmoil. The dollar crashed against the yen and plunged against the deutschemark.

There is a sound logic behind this behavior of the three currencies in times of serious crisis. In such a situation, most investors tend to do two things: they unwind existing leveraged positions, and they bring their money home into their own currency. It's a ridiculous assumption that in times of crisis European or Japanese investors do flee into the dollar because they consider their own currencies as unsafe. That kind of thinking is a relict of the Cold War. Internatonal financial turmoil essentially leads to mass flight out of the dollar and into yen and euro because the U.S. currency is most vulnerable for two reaseons: first, there is colossal foreign short-term indebtedness; and second, there is colossal leverage in the financial system. Taken together, there is the potential for a dollar collapse forcing Mr. Greenspan to raise interest rates in the midst of recession.

CONCLUSIONS:

The markets have grossly overbought the story of a synchronized global economic recovery that will fuel higher inflation. Leading economic indicators have in general turned up. But it's all too soon to speak of a self-accelerating recovery. Industrial production growth may have bottomed, but excess capacity continues to increase. Indeed, global trade is still contracting.

Risks to the bond markets from global overheating and rising inflation are nonexistent. The main risk is the potential need of international investors to unwind highly leveraged positions.

The key issue and the greatest risk to the global economy is a sharp fall of the dollar, triggering a correlative downward spiral of the stock market and the currency. It will rapidly shatter the illusions about the New Economy, of which the strong dollar was one of the great emblems. All this will have profound effects on the global economy and financial markets around the world.

We think that we are probably seeing the first stirrings of the coming dollar crisis. The strength of both the euro and the yen overwhelmingly reflect dollar weakness. How deep will the dollar fall? How deep can it fall? That's the only open question at this juncture.

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